that has to be taken into account.

MR. COOPER: I have no comment.

COMMISSIONER NESS: Okay. Last question, and that is for me, at least. Who believes that the FCC has the authority, when the statute says that contribution to universal service should be from all telecommunications carriers serving interstate on a competitively neutral basis, that we can impose a end user fee in lieu of charging specific categories of carriers for universal service.

Does anyone support that position? You believe that we can statutorily do that, and that that would be sufficient with respect to carriers contributing to universal service.

MR. WELLER: Yes. I believe if you could establish a fee as the mechanism through which the carriers would recover their contributions, ultimately, the carrier contributions have to come from somewhere. And the more and clear and explicit those contributions are, the better, I believe.

COMMISSIONER NESS: If one were to -- I kind of fibbed out it being my last question. But following up on that question, if one were to impose an end user charge, what would put downward pressure on the amount that would be imposed? In other words, how could that be computed away? Would it be competed away, or could it be computed away?

MR. WELLER: Commissioner, several ways. First, I think that you haven't taken the money out of the system. You've attached it to a different transaction. Today it's attached to access transactions, but the cost is really determined -- generated by local service. So, what you've done is you've take the money and you've attached the universal service support to the local service transaction, and the support's portable. So, I lose local customers, I lose that money, which I should do, because it's the money that supports those local customers.

What shouldn't happen is for me to lose the revenue that supports the local customers when I lose access minutes which is what's happening today.

The other thing I'd mention to you is that, as you remember, I've also proposed that the support amount itself not be left as static. I think that a competitive bidding process over time is the way to make sure that we have -- you've heard enough different opinions around this table, I think, to know one thing for sure, which is that you're not going to get exactly the right number when you finally do this. So, just in case we're wrong about this, we need to have another mechanism that will enforce market discipline on an amount. And I think competitive bidding is the way to do that.

COMMISSIONER NESS: Mr. Cooper, did you want to respond?

MR. COOPER: I think we know that auctions don't always produce the right number. It depends on who's available, which competitors can enter the market. I'm fine with auctions after there's competition, but not before.

COMMISSIONER NESS: Thank you, Mr. Chairman.

CHAIRMAN KENNARD: Chairman Johnson?

MS. JOHNSON: Yes. My question is directed back to some of the questions that Mr. Lubin made, and perhaps, Mr. Brown, you'd like to follow up.

Mr. Lubin, I guess under your analysis of what truly costs to serve are one, you've concluded that the revenues generated from R-1 plus CLEC covers costs, generally. And that we could, in fact, reduce access by -- substantially, immediately, and the world would be a better place.

Now, let's go to your world being a better place. So, what would that mean? And I don't mean to be flippant, but how will rate payers benefit? Who guarantees a flow-through, or will it be flow-through, or is there an obligation to flow it through? Could you respond?

MR. LUBIN: Sure. First of all, let me just ask one question. R-1 -- what is that?

MS. JOHNSON: Residential -- I think residential service. I'm sorry.

MR. LUBIN: Right. Okay. All right. I want to clarify something and than answer the specific question.

When we -- when I cited in my comments and than restated, and I said that if I look at the major LEC's and I look at the 69 -- I think it was 62 of 71 study areas had revenues in excess, that was looking at all revenues in terms of residents and business.

MS. JOHNSON: Okay.

MR. LUBIN: My belief is if I structured it, just for residents, you would see a similar thing, but you wouldn't see $23 billion. You would see still a number that's greater.

MS. JOHNSON: I'm sorry. You said you would still see a number that's greater?

MR. LUBIN: I believe the answer is yes, you'd still see -- but the $23 billion was really driven because business was included in that, and they looked at all local revenues including the interstate subscriber line charge.

The answer to your specific question in terms of follow the money and who will benefit, my view is ultimately, the consumer is going to benefit because those monies are going to be flowed through to lower prices for the consumer. And so, that's what I would expect to happen. That's what I would strongly see would happen.

MS. JOHNSON: Is that happening now?

collection, efficiency of distribution, we talk about an end user surcharge.

Other people talk about other mechanisms to do it. But the question is, what's most efficient, and where should the regulator be spending his or her time in terms of trying to create competition?

From where I sit, I see all the long distance companies. I see the revenue per minute declines on both business and residents, in the aggregate at least for AT&T, continually dropping of revenue per minute by billions of dollars, in excess of access.

My hope is that with your finite resources, that we try to figure out how to create local exchange competition and implement the rulings that have come out in August and in May of last year to try to create local competition. You know, sometimes I wake up in the morning and I say, "You know, we've got this huge debate. You know, is all the access being flowed through?" And I'm not suggesting this, because right now I don't have authority to suggest it.

But sometimes I wake up and I say, "Goodness gracious. We've got all these issues, universal service, local exchange competition." Sometimes I ask myself, "Are we just better off putting access on the bill and just letting that be on the bill? And as access comes down or goes up, just let it rip in terms of lower access."

Now, my fear is if that if somebody ever did that, you know, they would see rates in terms of various parts of the country that people really wouldn't want to see. And so, you know, I wake up sometimes saying, "Boy, I wish I could get out of this dilemma and this food fight." And that's how I see getting out of it.

And then I say, "But you know, if people really wanted to do that, you know, are they willing to accept the consequences of those actions?" Because, you know, in certain areas, it would really look nice. In other areas, it wouldn't look nice, because currently access is significantly de-averaged in this country.

MS. JOHNSON: Well, one of the points that Mr. Brown raised as we look at this, and you're right. The competitive market can give us some surprises. And as we transition into a competitive market, what should be the role of the legislator -- or regulator? Mr. Brown had suggested, "Well, maybe we shouldn't be so concerned about getting access to cost immediately, because having higher access will actually promote innovation and creativity and the market, and people will want to build these facilities." As a transitionary step, maybe we shouldn't go directly to costs because maybe that will be your distance in it.

Could you respond to that?

to R-1 customers? Should we be able to do that? Or can regulators do that, either Fed or states? And if the answer is yes, should they be able to do that?

MR. LUBIN: It's always hard for me to say what a regulator should and shouldn't do or what the legal ramifications are saying one should or shouldn't do. Since I'm not a lawyer, I can't attest to the legal ramifications of that. But in terms of the spirit of the question, it seems to me that we have over the last -- I don't know, 10, 15 years, moved to create competition in the LD marketplace.

And someone earlier said -- I think it was Commissioner Power, who at least alluded, at least if I understood it correctly, is that competition gets to be a very messy process. And when you're in a competitive marketplace, prices move toward costs. And as they move toward costs, than we access reductions. My view is those will get flowed through. And as you see more and more competition, at some point you may see in certain particular areas, prices move up.

And I'm not suggesting right now that an IXE is going to raise prices. All I'm saying is competition is an extremely messy process. And ultimately, it seems to me some questions should be asked in terms of -- you know, what are the most efficient ways of recovering some of these costs? And when I talk about efficiency and sufficiency of

MR. LUBIN: In my opinion --

MS. JOHNSON: With respect to access going down?

MR. LUBIN: Yes. With regard to AT&T, that's all I can speak for, is that we have continued to see that our revenues have declined significantly more than the access. We've seen that for the last several years, and we expect to see that on a continual basis.

So, the bottom line in terms of who benefits, I believe the consumer will benefit. And I believe the consumer will benefit by billions of dollars.

And by the way, I think ultimately, all of that's going to stimulate the pie so that the pie is simply bigger and bigger and bigger.

MS. JOHNSON: Is there a check and balance, or is there a mechanism by which the FCC can measure or the states or some regulatory body could measure the flow-through?

MR. LUBIN: Well, what we've done up to this point in time is respond to a Chairman letter that asked us, in terms of what has happened. We responded and showed that the revenue net of access has declined, at least for AT&T, significantly above and beyond access.

MS. JOHNSON: Should a regulatory body, FCC, states, be able to structure or require certain reduction, that the flow-through certain percentage must be applied to residential customers? Certain percentage should be applied

MR. LUBIN: Wonderful question from my point of view. And it's a tough question because it basically gets to the heart of, how do you want to manage the public policy issues? And you know, in May of 1997, the Commission came out with an order, a set of orders that addressed USF and access, and said, "Hey, let's go to that soft-landing approach, and let's get this checklist implemented." And thereby, giving everyone the opportunity of buy unbundled network elements disaggragated, and maybe even matching USF consistent with the level of geographical deaveraging of the loop, and let's be on with it.

Quite candidly, I thought that was a very rational approach. The dilemma is we put all of our eggs in one basket. That is, the basket of making the checklist truly operational. And for whatever reason, it's hard to legislate cooperation or to regulate cooperation. And I'm not saying anybody's doing bad things. It's just hard.

And my bottom line is, it's not working. And so, now you say, "Well, should I -- it's not working. Local competition isn't working. Should I keep access umbrella high to create the incentive? But what's the incentive if the piece parts aren't truly operational. What you do is the small CLEC will come in and slowly enter the market, but it's years and years. And so, I come back to the Chairman in terms of follow the money. You know, people will say, "Well, you're just going to pocket the money, and you're not going to flow it through." You can debate that.

But my view is follow the money and get it into the consumers hands sooner rather than later, and from my point of view, again, the key most critical area in terms of defining USF is the level of aggregation. If you go to the study area, my view is you're going to see a small fund. If you go below that, you're going to see, potentially, a larger fund. And then, bottom line is from my point of view, is to get access prices down, consumers will be far better off.

Sorry for taking the time.

CHAIRMAN KENNARD: Could I just tie one thing down from your answer, Joel? Am I to take from that response on flow-through, that you're not flowing through access reductions on a proportionate basis? That you're flowing them through, but you're not flowing them through to the R-1 consumers, necessarily?

MR. LUBIN: No. I'm glad you clarified the question. And my answer is and what we have shown is that we're flowing through more than the access reductions that we see. And my view is, that has been true for the last several years. In my view is the residential market also has seen access reductions and seen the benefit of those reductions. But when I said in aggregate, the aggregate --

I can't remember the number offhand. But the letter I think we highlighted was well in excess of a billion dollars.

I will say that this proportion amount of that in excess of the access reductions went into the business-side of the equation, but that isn't to say their fair share. And I would also highlight to this Commission and the Joint Board members, is that when we got price caps in the -- whenever -- I lost track, the mid-80s, late '80s, what we found is the price cap was disproportionately lowering the residential side of the equation.

That isn't to say, you know, that's bad or good. That's just simply to say, make the observations that when there was regulation in the heavy hand even thought it was price-capped, the way in which it was implemented disproportionately lowered that into the residential marketplace. But my view is -- bottom line is, well in excess of access in both for business and residence, but disproportionate to business.

CHAIRMAN KENNARD: Thank you. Commissioner Furchtgott-Roth?

COMMISSIONER FURCHTGOTT-ROTH: Thank you, Mr. Chairman. This has been just a wonderful session. I've learned a lot. And I see we're probably going to miss our break for lunch. But I will keep my comments very short.

In part, because in setting up this meeting, I know Chairman Kennard was very sensitive to the concerns of the states who very much wanted an opportunity to address questions to the panel that's here today. You've all done just a wonderful and very thoughtful job in making your presentations today, probably more than I have completely absorbed in the past couple of hours. But I look forward to trying to absorb them more in the coming weeks.

I just want to make a couple of points. There are too many of you for me to ask questions, and while I'm attempted to follow Commissioner Ness's lead, I'm probably not as good at asking the questions.

I hope all of you will leave today with two salient memories. One is that you addressed your comments to presentation before both Federal and state commissioners. And that a lot of the issues related to high cost ultimately involved consumers. They ultimately involved consumers in local telephony.

And the first point of Government oversight of local telephony is today. And I think what will remain in the dim and distant future, state regulators. It is to them and probably not to the Federal Communication Commission, that consumers will look first on matters of local telephone service. And frankly, just probably to the state regulators that telephone service providers will look first on matters of local telephone service.

We have a very difficult job before us, both at the Federal level and at the state level. I would urge all of you to work closely both with the Federal and state regulators. We've heard today presentations of 11 different plans, each of which, frankly, have a lot of merit.

At the end of the day, I am not at all certain that a single plan is going to be the best for every state or is going to be the best for every consumer. And it's quite possible that different states may, ultimately, adopt different plans. And that is entirely consistent with the Act, which envisions state universal service plans.

And I think it is entirely consistent with the Act that those issues need to be resolved before any of the other elements of universal service and 254 can be fully and adequately addressed. Thank you, Mr. Chairman.

CHAIRMAN KENNARD: Thank you, Commissioner. Commissioner Schoenfelder?

COMMISSIONER SCHOENFELDER: How many questions can I ask? Are we going to have time this afternoon for some questions?

CHAIRMAN KENNARD: Yes, we can continue on this afternoon.

COMMISSIONER SCHOENFELDER: Because I have several. But one of the things that I'd like to ask all of you who are local exchange carriers is -- and you can answer it one at a time or collectively. But I quite often hear and I've been hearing since we started this process that there's definitely a subsidy flow from business to residential, from business to local, however you want to call that.

I want to know if anyone -- and I'm looking at Mr. Brown now and since that's my local RBOC, he's going to get picked on, but I really want to know if anytime during your calculations you've ever taken traffic use or minutes of use into account when you talk about that subsidy flow, because if I am -- and I'm going to use my own state as an example. Citibank in Sioux Falls, South Dakota, and I'm Joe Sixpack on the corner, my traffic is going to be a lot different. And when you calculate, do you ever calculate minutes of use or traffic into that equation, and how you would you do it if you did it?

MR. BROWN: In the cost studies that we would file with the South Dakota Commission, yes, usage would be a component. It tends to be a relatively small component because we've switched to large switches. It tends to vary between customers. If you looked at my daughter's residential usage, who's a teenager, you'd probably find that she rivals many businesses. So, there's a mix.

But if I were to come to you and present a study for business and residents, it would have the usage built in, based upon averages, of course. And that's one of the problems with studies.

In the models that Joel's company and mine and actually several others on this panel have been working on, we tend to look more at what drives high cost. And that's the loop cost. So, there is usage in there but not with the granularity to answer a question like you just asked.

COMMISSIONER SCHOENFELDER: Anyone else? Okay. Then, as long as you're in front of me, in your new proposal, what is the size of the fund you're advocating? Can you quantify that?

MR. BROWN: Yes. Let me give you some numbers. These are going to be based on the common inputs. When model sponsors filed their models, they had default inputs. And frankly, we haven't looked at the inputs until just now because over the past year, we've been looking at the platform of the model. But the staff, I think, did a very good job of kind of looking at what we had both put on the table, and they came up with what I think are some middle ground estimates, cutting the baby in half, in many respects.

If you look and you run the benchmark cost proxy model or at the national aggregate, if you run the HAI model, you come up with a fund of roughly $4.5 billion to cover 100 percent of the cost above $31 for residents and

$51 for business. Those are the numbers that were in the May decision.

That would say, under the 25/75, the Federal fund would be about $1.1 billion or 25 percent. When you run the IHCAP or the two benchmark at 30 and 50, what you get is an interstate fund of $2.8 billion. That is 1.7 higher than existed under the 25/75. And the genesis for that is taking 75 percent of all of the costs over 50 dollars and moving them into the interstate jurisdiction.

In a sense, it's like the USF works today. When costs exceed 115 percent of the nationwide average, they're removed from the state jurisdiction and moved to the interstate jurisdiction and recovered through the fund.

What we're proposing is very analogous to that, and instead of 115 percent, you put loop costs from forwarding looking proxy model at a small area of geography above $50. But the mechanics beyond that are similar.

COMMISSIONER SCHOENFELDER: Let me follow up. Now, we're focusing today on non-rural companies. Are these non-rural numbers?

MR. BROWN: This is non-rural only.

COMMISSIONER SCHOENFELDER: And so, you still haven't added the rural component into the figures?

MR. BROWN: No. But I think the current fund for rural companies -- see, the whole name of the game in universal service funding is targeting to the areas where the high cost customers are. By historical accident if nothing else, and I think it's the reason why a small company is this in many places. They are small. They don't have urban areas to offset costs on, so I think the current funding for the rurals is a reasonable benchmark for what they would need.

COMMISSIONER SCHOENFELDER: Mr. Lubin, yes?

MR. LUBIN: Commissioner, I'd just like to make an observation in terms of the various plans relative to the current fund. The current fund is about $1.7 billion. That's the high costs, LTS and DEM. And then you have the various proposals that are being presented, and you have people looking at, calculating at a, let's say a serving wire center or a state average or, if you listen to us, it would be a study area. Just to give you a reference point.

The current FCC plan, the 25/75, would probably raise the money by about $400 million relative to the current plan. If you went to study area instead of serving wire center, it would be roughly comparable.

If you look at the majority member plan or the U.S. West plan, what we see is that if you use either -- again, the U.S. West Plan or the majority plan, you would still see about a billion dollar increase if you were at the serving wire center. So, instead of 1.7, you're at 2.7.

The interesting -- I'll use the word phenomena. This stuff always amazes me -- is that if you use the study area on the U.S. West plan, you come back to roughly the $1.7 billion number. If you use the majority plan, you come back at a study area level, roughly $2.2 billion. So, that case would be roughly $500 million.

My only message is that a key, key component are the input parameters and the level of aggregation that you use when you determine the fund, because you can use a level of aggregation that all of a sudden greatly changes that overall level of subsidy.

MR. BROWN: But whenever you hear the word aggregation, think implicit support. Think averaging. And the Act says you need to rely less on implicit support. The reason for that is that the urban areas --

COMMISSIONER SCHOENFELDER: I don't think the Act says that. I think the Act says that universal service should be explicit. I don't think it says anything about implicit support.

MR. BROWN: But in terms of measuring for explicit support is what we're talking about, the competition is going to hit first in the urban areas. You're going to have to reduce your prices toward costs faster there so you're not going to be able to average across the study area as Joel is suggesting when you use study area aggregation.

I have concerns even at the wire center, because within the wire center, you've got customers on Main Street that cost $10, $20 a month, even in an exchange that might cost on average, $100 a month. Do we want to throw, you know, a $70 or a $50 subsidy at a customer that costs $10 or $15 or $20 a month? I think that -- this whole area of aggregation deserves some very thoughtful consideration. But you can't just change your level of aggregation and not have other consequences.

COMMISSIONER SCHOENFELDER: Joel?

MR. SHIFFMAN: One thing that I think has been said which is somewhat confusing and might give the wrong idea is that the existing fund with its existing level of aggregation as Mr. Lubin talked about, meets the objectives of the Act.

And I guess that's one of the ad hoc's serious concerns is that the existing fund or even if the -- if the FCC went ahead and said, "We're just going to forget about this whole thing. Just leave the fund exactly like it is," we don't believe that even with that -- notwithstanding, the issue of competition, that the existing fund provides sufficient funds to afford comparable and affordable rates. And the reason that that is, is that -- and we did considerable regarding this.

That areas like Vermont and Maine and West

Virginia, which have large companies serving predominantly rural areas, get only pennies on the dollar to the extent that their costs exceed the national average, compared to similarly situated states that are served by small companies.

And that the combination of 200,000 line problem, the lack of switching recognizing really high switching costs are now being tied to company size, and the lack of anything in the high cost current fund recognizing high interoffice trunking costs, that those three factors put together create a situation where the existing fund, the status quo can't meet the standards and the objectives of Section 254.

Although, we've argued in pleadings that the 25/75 cannot meet the comparability and affordability objectives. But similarly, that even if we don't change the aggregation, the existing fund, the status quo, cannot comply to comport with the requirements of the Act.

COMMISSIONER SCHOENFELDER: Mr. Chairman, I have more, but I'll quite right now.

CHAIRMAN KENNARD: Okay. Well, you'll have some more time this afternoon. Commissioner Powell?

COMMISSIONER POWELL: In the interest of your schedule, I'll be happy to defer my questions until later.

CHAIRMAN KENNARD: Okay. Thank you. And with that, why don't we take our lunch break, and we'll reconvene here at 2:30. Thank you all very much.

(Whereupon, at 12:45 p.m., the meeting recessed, to reconvene this same day, Monday, June 8, 1998, at 2:30 p.m.)

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A F T E R N O O N   S E S S I O N

2:36 p.m.

CHAIRMAN KENNARD: Okay. Let's come to order for our afternoon session today. Commissioner Powell, I'm told, is en route back to the FCC. And so, until he gets back, I'm going to ask Martha Hogerty to proceed with her questioning, and than we'll double back and pick up Commissioner Powell's questions. Martha?

MS. HOGERTY: Thank you. Mr. Lubin, you're not the only one who's suggesting that perhaps competition should be considered or the development of competition should be considered as we move to universal service funding. How would you -- I know that you have said let's size it based upon the various density zones for the UNE. I mean, do you have anything more specific in your proposals? I mean, initially, AT&T, I think, supported the HAI and everything that went along with it. So, you have changed your approach somewhat in recognition of the lack of competition?

MR. LUBIN: Yes.

MS. HOGERTY: A couple of questions there I've asked you, I think.

MR. LUBIN: Should I begin?

MS. HOGERTY: Yes.

MR. LUBIN: Okay. I appreciate the question because some people ask us, have we changed our position with regard to the proxy tool? And our answer to that is no. We would hope, quite candidly, that the Commission make a decision on the proxy tool. We think the Hatfield, HAI, tool is a very flexible tool. We think it's very open. And it's using information that's public such that as more public information becomes open, you can modify and update the answers if better data becomes available.

It's also a tool that attempts to geocode the locations such that it's looking at a hundred million customer's specific locations, and it's attempting to geocode as many of them as humanly possible. Geocoding simply means looking at latitude and longitude of a customer location.

All that being said, we think it's right, quite candidly, to make a decision on the proxy tool. We would hope that it would be the Hatfield tool.

Where there is a difference in terms of what we have said in the past, I'll say a year ago versus today, is given the state of local exchange competition, we would suggest that the level of aggregation be the study area, again, because we don't see UNE's disaggragated at a wire center, or some states only have one unbundled network element rate. And so, I want to separate the issue of aggregation versus selection of a model, and a proceeding that I believe the FCC has under way in terms of trying to figure out what are the other input parameters to go into a model that hopefully is open and people could evaluate, et cetera.

All that being said, the next question we said is, "You know what? Even if you pick the proxy tool, even if you select study area, you really don't have to implement this until you see local exchange competition." And so, the final, at least the question I think I'm hearing you, you know is, when is that?

We've identified a set of metrics that we have put in our May 15 comments that would suggest, from our point of view, is again, the Commission has a series of orders trying to implement unbundled network and OSS's, et cetera, because we would hope those things get implemented. And that, ultimately, now a test we would say is, "Okay. Get it implemented." Once we see some penetration, I think we've put in a number of 15 percent penetration. That's indicative that this process is working.

But we would even go one step further in our comments. We said that, "By the way, even if you lose 15 percent, there's still may not be an earnings problem, and you ought to evaluate whether there's truly an earnings problem before you implement." And we suggested that the earnings problem could be evaluated based on the FCC's low end adjustment on price cap regulation.

So, those are the things we have said in the record.

MS. HOGERTY: Okay. And you've also said that, based on your study, you believe that local revenues when you look at all the revenues, are greater than the forward looking costs in those areas as you have aggregated --

MR. LUBIN: Yes. For the major local companies, we have put in the record, we --

MS. HOGERTY: For the large companies?

MR. LUBIN: Right. Sixty-two out of seventy-one study areas, that is true when you include local revenues including the interstate subscriber line charge.

MS. HOGERTY: Okay. And from that you have said, therefore, access is not necessarily a subsidy.

MR. LUBIN: Correct.

MS. HOGERTY: Well, what is it?

MR. LUBIN: Well, I mean, you can hear Lubin's view or AT&T's view is that we think there's a lot of excess that is in access. We would urge the FCC to immediately lower those prices, set a proceeding. We believe that the productivity factor, even though it's at 6.5, and we commend the Commission for going up from where it was to 6.5. We think using the own FCC data, could support a 9.3 or 8.4 percent productivity offset, reinitialize that to 1995 would